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Johannsen, Nicolas August Ludwig Jacob

The true way for deflation

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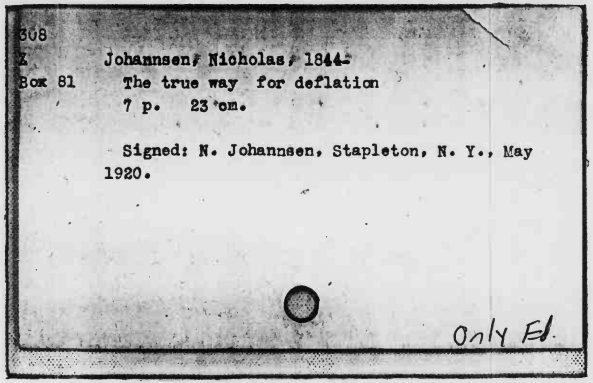

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The True Way
FOR DEFLATION

At the recent meeting of the Academy of Political Science the subject of deflation was discussed by a number of distinguished men, experts in finance and economics. Did any one of them suggest a feasible remedy, such as could easily be enforced without heaping new troubles on the old? No.

The broad suggestion to "cut down the credit facilities granted by the Federal banks" will hardly be relished by the host of business men who are in urgent need of funds. The suggestion that "people should work and produce more and spend less" is hardly enforceable, also loses sight of the fact that the greater production is not feasible unless accompanied by greater consumption. Even a complaint was heard that we export such a mass of goods, thus curtailing the home supply, making goods scant and dear! Also the Washington hobby was mentioned, "to curb stock speculation on margin"—without considering that the money is not in existence to fund all stocks (as well as Government bonds) now held on margin, and that if such curbing would freeze Mr. Dwarf out of his stocks, forcing him to sell them to Mr. Giant, the latter would just as well have to hold them on margin; only that he could find ways to do it, where Mr. Dwarf could not.

A danger not noticed thus far.—Before the war our annual export balance averaged $400,000,000 to $500,000,000. Did we get gold from abroad in settlement? No, none to speak of. That balance was eaten up by various items not covered by statistical information: ocean freights in foreign vessels, expenditures of American tourists abroad, smuggling or undervaluation of precious stones and other goods, remittances of immigrants to the old country, etc. As it was, the foreign *account* practically balanced, despite the great export surplus. In the year 1919 the export balance did not foot up a mere $500,000,000 but over $3,000,000,000. Assuming the invisible items to foot up the same as before, we should have received nearly $3,000,000,000 in gold from abroad in settlement of the foreign account. Instead of that we *sent out* over $300,000,000. What became of that favorable trade balance

of $3,000,000,000? Nobody is able to tell, though the matter is certainly worth while to be investigated by the Government. Every exporter received from the bankers the money for the shipments he made, but the money did not come from abroad.

The danger threatening us becomes clear when we consider that, in the judgment of the best experts, such enormous excess exports cannot be continued in the long run. If at present they do not balance our foreign account, despite their stupendous amount, where will we be when they fall off to a more normal figure? Will their falling off necessitate a corresponding increase of our gold exports—where our present exports of gold already have brought so much disturbance to the money market, making it difficult to borrow funds even against high security and, at times, jacking up the rate of interest to 10, 15 and 20 per cent.? Years ago our bankers protested against the importation of gold, asserting "we have no use for it, it will merely lead to inflation"—but now we have the inflation of all prices even where we are *losing* gold. The danger thus looming up before us renders it all the more imperative to find the true cause of the present distortion of all price conditions, also the true remedy.

The cause of inflation.—To adjust matters we should not try to merely doctor one of the symptoms of the trouble (the great volume of credit money, all of it direly needed) but should get at the cause of it and remove this cause.

Was the high cost of living, the climbing of all prices, and, necessitated thereby, the increased volume of credit money, was all this caused merely by the credit facilities afforded by our excellent banking system, or was it caused by the war?

The war created an unprecedented demand for labor, at the same time removing millions of men from the fields of useful labor. In consequence the demand for workmen became excessive. High wages were offered for all government work, in consequence of which the scale of wages was affected all through the country, rising to figures not heard of before, and naturally increasing the cost of all commodities. When the soldiers were disbanded, many of them did not return to their former occupation, but rather went idle if they could not get a job with high wages and short hours, so the former total of working forces was not restored. In addition, a new demand for working forces sprung up, calling for more of them than were available, namely, the urgent need of repairs and new constructions. Think of the shortage of houses.

& June 1920 Spr

Think of the repairs and replacements needed by the railroads to make up for what was neglected since years.

Usually the country's available working forces are pretty fully absorbed, the larger part in the production and distribution of commodities, and a fair share in construction and extension work. Activity in the latter line had largely been postponed for years on account of the war. But now not only the demand for the usual constructive work but also the postponed demand, has become urgent all over, calling on the one hand for more working forces than are available, and on the other hand for more and more funds, more than our credit system ought to supply in order to keep in a healthy condition. These two factors, the excessive demand for working forces (causing a constant rise in wages and therewith of prices and of the cost of living) and the excessive demand for new constructions (causing the unhealthy demand for cash funds and the high rates of interest) go hand in hand with each other. Adjust the one and therewith you adjust the other.

There is no necessity that so many new enterprises and new constructions should be tackled and finished all at once. To do so would still more increase wages and prices and would be followed sooner or later by a collapse, whenever the demand for new constructions relaxes. Much healthier conditions would be attained if the constructive energy were divided up over a number of years—and this is what I recommend as the remedy.

The remedy.—At the meeting it was said "the proper way for deflation would be to go ahead and deflate"—meaning to curb the country's credit facilities. I suggest that we first remove the main cause of *inflation*, then deflation will follow automatically. The inflation is largely due to the great demand for funds, necessitated for new constructions and extensions, enterprises and repairs. Let us scrutinize these, allowing credit funds for such as are really urgent, but not allowing them for such as are not so urgent. All necessities for repairs and replacements should be favored, especially those of the railroads; also the credit requirements for building houses, for extending the oil industry, and for all purposes intended to meet real and urgent requirements, but let us postpone granting credit funds for requirements not so urgent.

You may ask, "Is the postponement of new enterprises, new constructions and extensions, actually sufficient to produce deflation, and to relieve the urgent demand for labor?" In reply will say, if new enterprises and constructions were completely stopped,

we would speedily enter a period of business depression such as we never experienced before. All men now engaged in new enterprises and constructions would lose their employment, their income, and most of their purchasing power; this loss of purchasing power would react upon the men engaged in the production and distribution of commodities, reducing their employment, income, and purchasing power too; this again would react upon still other lines of production, spreading from the one to the other, and setting the vicious circle in motion.

A complete *lack* of enterprise, progress, and new constructions will lead us to business depression and to Chinese conditions; an *excess* of enterprise and new constructions, such as we now have, will lead to a steady rise of prices and wages, to a craving for cash funds and credit money, and to a final collapse—likewise to be followed by business depression, as in 1907. The happy medium between the two, such as would insure a continuance of prosperous conditions, should guard against overdoing things all at one time, and should set a limit to enterprise and new constructions when growing to excess. But the limitation should be applied to just such lines of enterprise as are not specially urgent. How can we adjust this?

Applying the remedy.—There is no department so competent to draw the line as the Federal Reserve Board, the managers and guardians of our excellent credit system.

Any company intending to go into a new enterprise, structure, or extension, needing an investment of $100,000 or more, should be held to give notice to that effect to the Federal Reserve Bank of the district, stating where the necessary cash funds come from; and if these are to be borrowed from a member bank, to an extent of $100,000 or more, the loaning member bank or banks should not be allowed to issue the required credits unless a permit be procured from the Federal Bank.

The latter will scrutinize the urgency of the enterprise, going by regulations received from Washington to that effect, and granting the permit if, in view of trade conditions, immediate procedure should be deemed desirable. If not deemed urgent, the condition of the money market in the district should decide whether the Federal Bank can be liberal in granting an early permit or whether postponement is indicated.

It should not be difficult for the government to keep tab, through the postoffices or otherwise, an any new constructions or enterprises

going on, and if these are undertaken without a permit, the bank examiner should sharply investigate the bank accounts of the individual partners to the enterprise, requesting the bank to close their accounts unless these partners submit full evidence to show that no money was borrowed to start or continue the enterprise. If the member bank refuses to obey, its rediscount facilities with the Federal Bank will be cut off.

The foregoing states just the outlines, without going into details, how to enforce a reduction of the excessive demand for credit funds. Provisions could be made to extend the control to non-member banks, also to guard against borrowing credit money under pseudonym bank accounts. If desirable, the control could be further extended to enterprises needing less than $100,000, and to private individuals; in reality, however, this may not be necessary, as the bulk of *new* credit requirements emanates from companies, generally calling for large amounts.

The principle would likewise afford a convenient leverage against the hoarding of sugar, eggs, victuals and other goods, undertaken for the purpose of raising the prices by making the goods scarce. Thus the latter could often be forced out into the market if by direction from Washington the credit funds necessary to hold them were refused.

* * *

Well-meaning men have repeatedly advised us to give financial aid (credit) to the distressed countries of Europe—this despite the fact that we ourvelves are in sore need of credit funds necessary to meet our own requirements. If we are to help Europe, it is all the more obvious that first of all we must reduce or postpone our own requirements for cash funds and additional credit money —which can be done only by postponing the enterprises which such funds would be wanted for. Then we could help Europe and, as shown above, would also secure better permanence to our own prosperous conditions.

From a mere bankers' standpoint the inflation of prices and wages is due entirely to the excessive amount of money in the country (bank money as well as paper money) and this again to the case of increasing the volume of credit money up to the very limit; so they conclude that by merely cutting down the volume of credit money things will righten themselves—a great mistake. To forcibly reduce credit facilities without first reducing the cause from which the great demand for same originates, that is bad

policy. The true cause must be found in the multitude of new undertakings, all of which need investment funds and are clamoring for extending bank credits. Postpone these undertakings, so far as not really urgent, and you will relax both, the demand for credit funds *and the abnormal demand for working forces, more than there are available.* Without the forcible postponement suggested above, such non-urgent enterprises will more than the others push themselves to the front.

A further onslaught on the country's credit facilities would be the bonus suggested to be awarded to all disbanded soldiers. My advice is, be liberal with the widows of the killed and with the crippled, but let the others go to work and earn their living.

Finally a word about Liberty bonds, which the Government has simply left to their fate. On the one hand they are constantly losing in value, on the other hand they are reducing, to an undue extent, the credit facilities of the commercial banks, of which they absorb over $6,000,000,000. To relieve this latter exigency somewhat, I suggest that the legal reserve which the banks are required to hold on their deposits, be reduced by five per cent. (more or less) of the amount of the war bonds they have on hand, whether owned or held as collateral; also that all member banks should be obligated to advance loans on a proportionate share of all war bonds now in the care of the member banks, namely, a share proportionate to their capital plus surplus; also that on war bond loans the banks should not charge a higher rate of interest than the bonds yield. The real cause for the decline of the bonds must be found in the fact that their owners can employ the money to better advantage elsewhere; say, in Wall Street, where they can buy stocks like Steel, Bethlehem, Cities Service, &c., which offer both a higher income and brilliant prospects for the future. Washington does not favor investments in Wall Street; and whenever a move is made there for higher prices, we hear of threats to cut down credit facilities and of complaints that such speculation absorbs funds needed for other purposes. (Is this true? Even for margin business? Suppose a man owns 100 shares Steel stock, on which he paid $3,000 margin while his bank advanced $7,000, and that subsequently the market price advances from $100 to $200 per share, whereupon he borrows $7,000 more from the bank, which amount he invests in building a factory. Washington will say, "There you have it, $7,000 absorbed by stock speculation"; I say, "No, the $7,000 have been absorbed to build the factory,

even though the bank now has to report $14,000, instead of $7,000, as loaned on stock collateral; its report, therefore, is misleading, and Washington's attack is not warranted. The mere rise of stocks does not absorb any funds at all; if funds are absorbed thereby, these are used for other purposes—and such other use could be curbed very effectively, *if necessary,* by the remedy stated before, and could be led into the desirable direction.) I sincerely believe that if Wall Street prices were allowed to rise to figures corresponding to the intrinsic values of the properties, this would be a great boon to our war bonds and would help these to likewise find their true level. They would not look comparatively dear any more.

* * *

If the plan now considered at Washington were followed, to reduce inflation simply by curbing the credit facilities, the scramble for cash funds would become worse than ever. If *my* plan were followed, the scramble would cease; and there would be deflation not only in the money market but also in the prices of commodities and labor.

The plan may seem complicated; but consider: for the building of every house a detailed plan must be submitted to the authorities, millions of them; is it too much to ask that the few thousand of large new enterprises should likewise ask for permits and should state where the necessary funds come from—where regulations in this line are so highly important for the continuance of our prosperous conditions?

N. JOHANNSEN.

Stapleton, N. Y., May, 1920.

Criticism, mailed to me will be welcome.

P. S.—A few days after the foregoing article went into printers' hands, the Federal Reserve Bank of New York published the same view as to where to apply the remedy, advising the limitation of new enterprises, so as to reduce the demand for credit. While it is highly gratifying that such a high authority held out the same fundamental view for solving the important problem, the Federal Bank failed to show how to enforce the remedy. Without enforcement the remedy is of no avail. A permit should be required for all new structures and enterprises of importance.

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